In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 943

HOWARD DAVIS, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 247-257) are not officially reported. The opinion of the Court of Appeals (App. 3a-10a)[1] is reported at 239 F. 2d 187.

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[1] Appendix references are to the Appendix to the petition for certiorari.

JURISDICTION

The judgment of the Court of Appeals affirming the Tax Court's decision was entered on December 13, 1956. (App. 10a.) On March 13, 1957, the time for filing a petition for certiorari was extended until April 27, 1957. The petition for a writ of certiorari was filed on April 26, 1957. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. 1254.

QUESTIONS PRESENTED

1. Whether the Tax Court and the Court of Appeals correctly determined the taxpayer's net income by use of the net worth method.

2. Whether the Tax Court and the Court of Appeals correctly found that a part of the deficiency for each of the taxable years was due to fraud with intent to evade tax.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 293. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY.
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> * * * * *
>
> (b) *Fraud.*—If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612(d)(2).
>
> (26 U.S.C., 1952 ed., Sec. 293.)

STATEMENT

Taxpayer was engaged in the business of growing, buying, processing and selling popcorn. (R. 249.) Adjusted gross income from such business, for the years 1942 through 1945, was reported in the following amounts (R. 252):

1942	$ 4,978.14
1943	8,604.22
1944	17,679.56
1945	26,594.96
(Total	$57,856.88)

Asserting income tax deficiencies and fraud and delinquency penalties, the Commissioner computed taxpayer's income by the net worth method. This computation disclosed taxable income for the entire period in the amount of $302,412.29, which, on the basis of annual sales, was allocated to the four taxable years as follows (R. 7):

1942	$ 20,715.24
1943	59,091.36
1944	76,268.38
1945	146,337.31

A petition for redetermination having been filed in the Tax Court, taxpayer challenged the propriety of using the net worth method of computing income, the computation of his opening net worth, and the assertion of the fraud and delinquency penalties. (R. 252-253, 255-256.)

The facts found by the Tax Court with respect to these issues may be summarized as follows:

Records of purchases of popcorn and all records in connection with the farm and the processing of pop-

corn were maintained personally by taxpayer prior to and during the taxable years. These records, which consisted of a day book in which taxpayer recorded amounts paid out and received, were destroyed by fire in 1946 subsequent to the start of an investigation of taxpayer's income tax returns. No attempt was made physically to segregate popcorn which was purchased and popcorn which was grown by taxpayer. Taxpayer, in at least one of the taxable years involved, furnished his accountant who prepared his income tax returns with inventory and purchase figures based upon market price rather than cost. Taxpayer did not keep accurate inventory records and his books and records did not properly reflect his true income during the years 1942 to 1945 inclusive. (R. 250.)

At the beginning of the taxable period, taxpayer had approximately 1,800,000 pounds of popcorn stored in cribs on the family farm. This popcorn had been grown on the farm in 1941 or earlier years, or had been acquired under taxpayer's contracts with other farmers. Taxpayer also had some popcorn stored at his manufacturing plant and some stored on the farms of others. The popcorn which taxpayer had at the beginning of 1942 had cost approximately $31,352.[2] Tax-

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[2] This was one of the three controverted items appearing in the Commissioner's computation of taxpayer's assets at the starting point. On his income tax return for 1942 taxpayer had reported a beginning inventory of $9,221.46, and this was the figure credited to the taxpayer in the Commissioner's computation. (R. 8, 253.) In raising this figure to $31,352, the Tax Court pointed out that on a financial statement rendered as of April, 1942, taxpayer had estimated the cost of his "salable merchandise" at $31,352. The court found that this figure (which would give an average *cost* of about $1.74 per hundred pounds for 1,800,000 pounds of which petitioner had raised about 600,000 pounds him-

payer spent nearly all the cash he had or could borrow purchasing popcorn. He did not have in excess of $933[3] in cash at the end of that year. (R. 249.) Between January 1, 1935 and December 3, 1941, taxpayer was continuously borrowing sums up to $4,000 from the Pendleton Banking Company. He did not file an income tax return prior to 1942 when he filed a nontaxable return for 1941. There is no record of taxpayer's mother or father ever filing an income tax return. Taxpayer's father died on February 14, 1934, leaving personal property appraised at $10,653.03. (R. 249-250.)

Taxpayer's liabilities on January 1, 1942, exclusive of the amount borrowed from his mother, totalled $11,000. His living expenses were $5,000, $7,000, $12,000 and $10,000 in 1942, 1943, 1944, and 1945, respectively. (R. 251.)

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self) could be reconciled with the average *price* for popcorn which was $2.08 per hundred pounds in 1941 and less in 1940. (R. 253-254.)

[3] This was another of the three contested items in the Commissioner's computation of taxpayer's assets at the starting point. (R. 254-255.) With respect to this item the Tax Court stated (R. 254):

> Petitioner testified that he had $150,000 in cash when he rendered the financial statement of June 12, 1941. We find this testimony wholly unbelievable. Prior to mentioning this cash hoard, which had allegedly been hidden in the well pit of the milkhouse since 1936, petitioner testified several times that he was unable to name any assets which had been omitted from the statement of June 12, 1941.

The third disputed item was furniture. The Tax Court accepted taxpayer's testimony that he had $1,344.55 in furniture prior to 1942. (R. 255.)

Taxpayer filed financial statements with the Anderson Banking Company of Anderson, Indiana, showing a net worth on the dates indicated as follows:

June 12, 1941	$64,466.49[4]
April 1, 1942	74,093.00
January 3, 1944	112,549.00
January 3, 1945	126,602.78
November 10, 1945	430,634.92

Taxpayer certified each of these statements to be a true and correct statement of his financial condition at the time. (R. 251.)

Taxpayer's 1943 income tax return was filed on April 15, 1944. His purported income tax return for 1944, which was signed by the accountant who prepared it but not by taxpayer, was filed on March 9, 1945. (R. 248.)

The Tax Court concluded that taxpayer's net worth during the period January 1, 1942 to December 31, 1945, increased $230,357.94 (R. 251), and that his reported, actual and unreported adjusted gross income for each of the taxable years was as follows (R. 252):

Year	Reported	Actual	Unreported
1942	$ 4,978.14	$ 19,213.53	$ 14,235.39
1943	8,604.22	54,807.65	46,203.43
1944	17,679.56	70,739.45	53,059.89
1945	26,594.96	135,728.86	109,133.90

[4] The Commissioner's computation of taxpayer's opening net worth had credited him with $60,431.75 on December 31, 1941. (R. 8.) This figure, as adjusted by the Tax Court (changing inventories from $9,221.46 to $31,352, adding $1,344.55 in furniture, and changing liabilities from $3,387.71 to $11,000), was increased to $76,294.55.

The Tax Court also concluded that at least part of the resulting deficiency in each year was due to fraud with intent to evade tax. (R. 252.)

The Court of Appeals in a unanimous opinion affirmed the decision of the Tax Court. (App. 3a-10a.)

ARGUMENT

The factual and legal issues presented to the Tax Court and the Court of Appeals received careful consideration and were correctly decided. There is no conflict or other reason for further review.

1. The major issue presented to the Tax Court and the Court of Appeals concerned the propriety of the Commissioner's use of the net worth method to determine the taxpayer's correct net income. The contention of the taxpayer in the Tax Court and in the Court of Appeals was that in the absence of a showing of the inadequacy of the taxpayer's books and records or in the absence of a showing that concealment of income or falsity of books exists, the net worth method may not be used. The Court of Appeals, however, correctly recognized, in accordance with the decision of this Court in *Holland* v. *United States,* 348 U.S. 121, that proof of unreported income by the net worth method itself casts doubt on the reliability of a taxpayer's books and records and no preliminary showing of unreliability or falsity need be made. This is also in accord with decisions in other Courts of Appeals. Cf. *Thomas* v. *Commissioner* 223 F. 2d 83 (C.A. 6th); *Canton* v. *United States,* 226 F. 2d 313 (C.A. 8th). Moreover, as the Tax Court pointed out (R. 253), the books and records of the taxpayer were inadequate and the Court of Appeals expressly stated

(App. 5a) that "this finding is well supported by the evidence."

2. The only questions raised by the taxpayer in the Court of Appeals and the Tax Court, apart from the propriety of using the net worth method, related to the determination of opening net worth, specifically items of cash on hand and inventory, and the finding that a part of the deficiency for each of the taxable years (1942 through 1945, inclusive) was due to fraud with intent to evade tax. However, concurrent findings of two lower courts on such factual matters are entitled to finality in the absence of exceptional circumstances. Cf. *Comstock* v. *Group of Investors*, 335 U.S. 211, 213-214; *Allen* v. *Trust Co.*, 326 U.S. 630, 636; *Tennessee Coal Co.* v. *Muscoda Local*, 321 U.S. 590, 605.

The Court of Appeals (App. 6a-7a) approved the Tax Court's finding (R. 249) that the taxpayer's cash on hand on January 1, 1942, the beginning of the first taxable year, was $933. This amount was taken from a certified financial statement submitted by Davis to a bank in June, 1941. (Ex. B, R. 63, 195.) In April, 1942, Davis, in a similar certified statement, claimed he had $1,500. (Ex. C, R. 66, 197.) The record further established a long history of borrowing (Ex. P, R. 129, 242); no prior history of filing income tax returns, except for 1941, when a nontaxable return was filed (R. 249); and no likely sources of gifts or inheritances (R. 250) with which to amass the cash hoard of $150,000 which petitioner later "remembered" (R. 103, 127).[5] Indeed, in view of the Tax Court's

[5] "On cross-examination, taxpayer was repeatedly asked to state any assets which he owned that were not listed on the

characterization of the taxpayer's testimony as "wholly unbelievable" (R. 254) and "patently false" (R. 255), the Court of Appeals aptly characterized the Tax Court's allowance of $933 for opening cash on hand as a "generous" one (App. 7a).

The factual determination that Davis had an inventory of over $31,000 on January 1, 1942, being substantially more than the $9,221.46 (R. 253) claimed by him on his income tax return for 1942, is supportable by the admissions of the taxpayer on his return and the other evidence of record. The Tax Court and the Court of Appeals were certainly not bound to accept the subsequent testimony of Davis, which the Tax Court characterized as "generally unreliable." (R. 254.) *Staudenmaier* v. *Johnson,* 117 F. 2d 397 (C.A. 7th); *Cohen* v. *Commissioner,* 148 F. 2d 336 (C.A. 2d).

The finding of fraud was amply supported. The fact of the large understatement of income of $222,632.61 over a period of four consecutive years in relation to the reporting of only $57,856.88 (R. 252), the fact that Davis was spending money in excess of that reported by him (R. 35, 77, 251), his recognition that his "business has grown considerably each year and my net worth has gone up each year" (R. 186), the certified net worth statements submitted to a bank showing

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financial statement and he could not recall any. After a luncheon recess taxpayer 'remembered' that he had a cash hoard of $150,000 which had been hidden on his farm since 1936." Opinion of the Court of Appeals, App. 7a.

increases of over $350,000 in a period only slightly longer than that involved herein, and the fact that Davis reported income of only $26,594.96 (R. 252) for the year 1945, after his accountant informed him (R. 243) that his income computed on a cash basis was almost $60,000 for the first ten months of 1945 and about $117,000 computed on an accrual basis (which Davis should have been using since he kept inventories, Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939, Secs. 29.41-2 and 29.41-3(1)), when coupled with the fact that Davis attempted to fabricate a "patently false" and "wholly unbelievable" story (R. 254, 255), fully warrant the finding approved by the Court of Appeals, that a part of the deficiencies for each of the taxable years was due to fraud with intent to evade tax. The record amply demonstrates that the courts below[6] properly exercised their respective functions in passing on these factual issues.[7]

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[6] The Tax Court did not resolve all of the factual issues presented to it adversely to the taxpayer. Because of certain adjustments made by it the net income of the taxpayer as determined by the Commissioner was reduced about $20,000. (Cf. R. 7, 252.) The Commissioner did not seek review of these adverse determinations.

[7] In his petition, the taxpayer raises issues not previously brought to the attention of either of the courts below. While this in itself should preclude consideration being given to them by this Court (cf. *General Utilities* v. *Helvering*, 296 U.S. 200, 206), we submit that they are without merit and do not warrant the grant of the petition. The claim that the taxpayer was a farmer and the net worth method is not available in cases involving farmers (Pet. 2, 12-13) is wholly unsupported by the citation of any authority. There is no justification of a special exception from the net worth method for farmers. In any event,

(*Continued on page 11*)

the magnitude of popcorn sales as compared to farm expenses (R. 251) shows that during the tax years, the taxpayer was principally a manufacturer and seller of popcorn and not a farmer. Moreover, the claim that inventories should not be used in computing the net worth of farmers (Pet. 12) is baseless. Although farmers may report income without using inventories, they may, on the other hand, elect to use inventories, as the taxpayer did on his tax returns. (See R. 253.) Treasury Regulations 111, Section 29.22(a)-7. And the taxpayer's election to use inventories required him to be on the accrual basis of accounting. Treasury Regulations 111, Sections 29.41-2 and 29.41-3. The contention (Pet. 4) that the taxpayer's liability to his mother should have been taken into account is shown to be without merit by the Tax Court's recognition that this liability at the beginning of the period was offset by a corresponding liability at the end of the period. (R. 255.)

The allocation of the unreported income for the four-year period to each of the taxable years by using a ratio based upon sales, now contested by taxpayer, is certainly a reasonable one. The inadequacy of taxpayer's books and records, a situation of the taxpayer's making, occasioned the use of this method and, in the circumstances present, the taxpayer at this point has no standing to complain. Cf. *Cohan* v. *Commissioner*, 39 F. 2d 540, 544 (C.A. 2d); *Lias* v. *Commissioner*, 235 F. 2d 879 (C.A. 4th), certiorari denied April 22, 1957; *Mikelberg* v. *Commissioner*, 23 T.C. 342, 350, affirmed *per curiam*, 234 F. 2d 34 (C.A. 3d), certiorari denied, 352 U.S. 968; *Archer* v. *Commissioner*, 227 F. 2d 270, 273-274 (C.A. 5th); *Estate of Bartlett* v. *Commissioner*, 22 T.C. 1228, 1232. It may also be noted that the burden of proving error in the Commissioner's determination was upon the taxpayer and no effort was made by him in the Tax Court to show that the determination was incorrect for this reason.

The failure of the taxpayer to introduce any evidence that his failure to file a valid return for the year 1944 was due to reasonable cause rather than wilful neglect within the meaning of Section 291 of the Internal Revenue Code of 1939 (R. 256-257), an issue on which he also had the burden of proof (cf. *Coates* v. *Commissioner*, 234 F. 2d 459 (C.A. 8th); *Sanders* v. *Commissioner*, 225 F. 2d 629, 637 (C.A. 10th); *Lee* v. *Commissioner*, 227 F. 2d 181, 184 (C.A. 5th)), establishes the correctness of the Tax Court's decision on this issue.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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